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Stock Market Update—
It's a Bear Market, So Where Do We Go From Here?

On March 15 the large company US stock market, as represented by the S&P 500 Index, closed down 23% from its high. The overall stock market is dealing with an old-fashioned bear. For the first time in the investment lives of many market participants, stocks have experienced an extended decline instead of the quick and less- painful corrections of the past 15 years.

Thankfully for those who have remained diversified, everything is not declining, and this characterizes the overwhelming number of our clients. Even though returns were not particularly satisfying on an absolute basis, the full year performance for our clients' portfolios substantially exceeded their benchmarks. One of our major goals is to deliver benchmark-beating long-term returns for our clients that are satisfying on both an absolute and relative return basis.

Is the stock market a bargain yet?

Not based on our analysis. Relying on our standard assumptions, our valuation model puts the stock market right at fair value. The current economic environment is murky, however, and other factors affecting companies' earnings make it impossible to be know.

How much lower could the S&P 500 go?

No one can say for sure but we can get a sense for the worst case. In recessions, earnings can decline 15% to 20%. At present, earnings are still forecasted to grow in 2001, but barely. However, earnings forecasts are being ratcheted down quickly and are probably still overly optimistic. Analysts usually don't do a good job of forecasting cyclical earnings declines. To quantify a worst case, let's say earnings decline 15% in 2001. If that happened the economy would be very weak and interest rates would probably be lower. If we assume a 4.5% 10-year treasury yield and a 15% earnings decline from 2000 levels, the market would need to decline another 12% or so to be at fair value based on our valuation model. In that scenario it is very possible that stocks could overshoot on the downside—something that has happened often in past bear markets. Overshoots have generally fallen in the 10% to 15% range suggesting a "worst-case" decline from here of about 25%.

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But isn't this already a rather lengthy and sizable bear market?

It definitely qualifies as a real bear. However, the prices of so many stocks were so high before that it is very possible that it will take a larger-than-normal decline before we start a new cycle. Still it is likely that we are more than half way through this bear in terms of time and the magnitude of the decline. And it is possible that we are very near the end.

What about growth and tech stocks?

As with the overall market, they are still not clearly cheap. As of March 12, the Russell 1000 Growth Index (a large growth company index) is still expensive relative to the Russell 1000 Value. How expensive is a tougher question. There are a lot of variables that effect this—short-term and longer-term growth rates, interest rates, investor sentiment, etc.—and they are all very fluid and uncertain right now. Even if we assume a relatively quick turnaround for the economy and a best-case scenario for large-cap growth earnings over the next five years, large growth still isn't cheap. Holding all other things equal, many large capitalized growth company stocks may have prices that are still 10%-25% higher than traditional valuation models would indicate their prices should be.

As for tech stocks, earnings forecasts have dropped like a rock and continue to decline. If anything, this may indicate tech stocks have farther to fall.

What are possible long-term implications?

One possibility is for a long, difficult recovery for growth stocks. After the 1973-74 bear market that unwound the Nifty Fifty growth stock era, growth stocks fell far more than the rest of the market and underperformed for many years. Investors had been burned and chose to stay away from many high-quality companies. We don't know whether this will happen again and we wouldn't be confident basing an investment strategy on this analysis.

Our approach.

In a real bear market there are no sure-fire safe havens, but diversification certainly helps reduce volatility. Your portfolio is designed to benefit from diversification. So we aren't recommending any dramatic move in your asset allocation. We are looking to spot opportunities as they arise, and if conditions deteriorate further in the growth stock arena we may shift our growth / value ratios. We're also looking at strategies to take advantage of a low interest rate environment (it may be time to refinance your mortgage). We'll keep you apprised. In the meantime please contact us if you would like to discuss any aspect of your portfolio or recent events.

Sincerely yours,

Frederic P. Kutscher

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